Testimony before the Senate Finance Committee
Subcommittee on Taxation and IRS Oversight
on “Preserving and Protecting Family Business Legacies”

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Introduction

Mr. Chairman and members of the Committee:

I am distinctly honored to appear before this distinguished Committee, on a topic of undeniable national importance and particular personal interest: Preserving and Protecting Family Business Legacies. My perspective on this issue relates to the economic research I have conducted on the effect of the estate tax and related treatment of capital gains going back as far as my Harvard Ph.D. Economics dissertation almost a half-century ago, as well as numerous professional journal articles I have written since then. I, and my colleagues at CONSAD Research Corporation, the policy analysis firm I formed in 1963, are currently involved in various research projects on this topic. Moreover, I have presented briefings and advisories on this subject to almost every President since John F. Kennedy and Lyndon Johnson, including Presidents George Bush and William Clinton, as well as numerous, outstanding members of Congress. Today's session, however, stands out among the rest in its importance as an opportunity to identify problems faced by families and businesses due to the estate tax, and potential solutions, the possible reform or elimination of the estate tax and potential changes in tax treatment of capital gains, both realized and unrealized.

Summary of effects of reducing or eliminating the estate tax

There is a lengthy and complex history to deliberations regarding the estate tax and capital gains. These hearings are unique, however, since they involve discussions of the positive economic effects on family business and workers of reducing or eliminating the estate tax, and of the benefits of freeing locked-in capital markets.

First, I would like to address the issue of the magnitude of the problem. We should explore exactly who is impacted. Those in favor of keeping the tax assert, “Less than one percent of taxable estates are comprised of family-owned businesses.” This assertion is based on an extremely restrictive definition for a family-owned business.

We were able to find a more accurate measure for defining the financial attributes of an estate that includes a family-owned business, the summary data that the Internal Revenue Service (IRS) has compiled from estate tax returns indicate that the assets of family-owned businesses are sizable portions of the estates reported on a substantial percentage of taxable estate tax returns. Rather than being less than 500 in a typical year, the total number of taxable estates that consist largely of family-owned businesses likely exceeds 10,000 annually.

Based on research by myself and my colleagues, we believe that important benefits would result from the reduction or elimination of the estate tax and, in the context of repeal, changing the basis for taxing capital gains. These benefits include the following:

- **Economic effects are positive**. Currently, many small business owners, and estates with non-liquid assets, must break up their business or holdings in order to raise money to pay their estate tax debts. All sides of the debate agree that this has a considerable disruptive effect on many family businesses, including farmers. Proposals to reduce or eliminate the estate tax would make it much easier for these businesses to continue to operate without undue disruption. The research my firm has conducted estimates the macroeconomic consequence of the elimination or substantial reduction of the estate tax, i.e., the extent to which these would beneficially affect jobs, national income, and economic output. While we did not consider (in that report) the revenue and economic effects of the carryover of basis, as called for in many legislative proposals, we continue to believe that the investment and liquidity-enhancing effects of the elimination or reduction of the estate tax will increase the survivability of family business and their positive effects on local and regional economies. Our research also confirms the benefits of speeding these effects, e.g., through immediate reduction or elimination, particularly if and as economic conditions worsen.

- **Revenue losses will be lower than currently anticipated**. Experts differ on the estimates of the precise revenue consequences of both eliminating the estate tax and changing the tax treatment of capital gains. Our ongoing research appears to indicate that the revenue gain from the correlate change to the carryover basis will yield annual revenue gains beginning at $5 billion and gradually rising to more than $15 billion yearly. The change in basis at death will lead to more revenue gains than are currently contemplated.

- **Approximately fifteen trillion dollars (more or less) of unrealized capital gains will become more free and fluid to serve the interests of American businesses and their workers**. We have come to know, through research and judgment [Steger, 1957; Gravelle and Lindsey, 1988; Burman, *et al.*, 1997; Auten and Joulfaian, 2001 (forthcoming)] that there is an immense pool of accrued but yet **unrealized capital gains. By my own estimates, these currently amount to as much as $15 trillion**, and are growing. Proposals to transition from the stepped-up tax basis for capital gains to the carryover basis will result in increased revenues, partially offsetting the loss in estate tax revenues. The stepped-up basis will, by and large, diminish in importance with the elimination of the estate tax.

- **Preserving family businesses.** Currently, families and estate executors face a complicated set of overlapping tax rules that include the estate tax, capital gains tax, and the gift tax. Many Americans devote considerable time and resources on estate planning to arrange their personal and business affairs in an attempt to minimize their total taxes at death. Unfortunately, without such planning, some estates face an unnecessarily high tax burden that hurts families and small businesses. In the ideal economic model, the simplification of the tax code that would flow from the elimination of the estate tax would result in a clearer picture of expected tax burdens at death, and free up resources now spent on navigating the maze of the tax code.

More detailed information characterizing the magnitude and composition of the effects of eliminating the estate tax and unlocking unrealized capital gains is presented in the following section.

Background and History

Since the middle of the last century, this subject has enjoyed an active history. Not surprisingly, during the early years of the Clinton Administration, the President’s economic think-tank called for an end to the (income) tax exemption for unrealized capital gains held when a person dies. This proposal cited an ultimate revenue yield of $5 billion per year as well as enhanced equity as justifications (Shapiro, 1992). This marked the approximately fiftieth anniversary of the pathbreaking article on this subject -- with a similar objective to Clinton's -- by the celebrated income tax specialist and reformer, Stanley S. Surrey (Surrey, 1941).

Professor Surrey was destined to bring this important notion, and an affirmative assessment of its constitutional validity, to the attention of Presidents Kennedy and Johnson while serving as their Assistant Secretary of the Treasury for Tax Policy during the 1960s. Under President Johnson, a Treasury Department study recommended taxing gains as income on a decedent's final tax return. Then House Ways and Means Chairman Wilbur Mills, working with Surrey and myself (Steger, 1957, 1961) during this period, held committee hearings on this and closely related income and estate tax subjects (Steger, 1959; Heller, 1955). Also during this period, leading public finance economists of the day (F.M. Bator, R. Blough, J.K. Butters, R.F. Gemmill, J.K. Lintner, L.H. Seltzer, H.M. Somers, L.E. Thompson, and others) provided excellent insights into prospective economic and equity effects of taxing capital gains as though realized at death and/or disallowing the stepped-up basis.

In 1976, the House Ways and Means Committee considered alternatives to the stepped-up basis including a basis carryover and/or an additional estate tax; indeed, the 1976 Tax Reform Act enacted the carryover basis, but it was repealed in 1980. President Carter was the first President to attempt to implement the carry-over of the descendent's basis at death through Internal Revenue Service (IRS) action. The IRS attempted to implement this concept in the late seventies but was thwarted (President Carter recalls) by "difficult administrative problems" such as estimating the original basis. The IRS discontinued this program after a short trial, though I recall that President Carter believed that, with more resources and time, the carryover of basis could, feasibly, be implemented. Presidents Nixon (through Wilbur Mills), Reagan and Bush appear to have been apprised of the revenue, economic and equity effects of the treatment of unrealized capital gains at death, though no legislative or administrative proposals for reform appear to have been set forth during this period.

Pertinent research analyses during the Clinton Administration, included:

1. A CBO Papers review (CBO, June, 1991), estimated three different revenue outcomes (depending on the taxing statute): a maximum of $19.0 billion over five years by including the gain (as though constructively realized) in the last income tax return of the decedent and enacting a supplemental 10% estate tax: versus a minimum of $5.2 billion over five years, by enacting a carryover of the decedent's basis.

2. The 1992 Tax Expenditures analysis (U.S. Office of Management and Budget, 1992) of the stepped-up basis, showing "outlay equivalents" of $29.8 to $36.0 billion (1990-1992) and $22.1 to $26.8 billion (1990-1992) revenue loss.

3. Congressional committee studies of the stepped-up basis, using a variety of assumptions, place the estimate in the $15 to $17 billion range.

Tax expenditure estimates by the Treasury Department's Office of Tax Analysis, based on a retrospective analysis, are indeed quite high. Conversely, the CBO estimate of revenue gain appears to be low, as explained below. Such analyses are performed using different, but reconcilable, assumptions. The estimate in Mandate for Change (Shapiro, 1992), for example, assumes the continuation of the current exemption for capital gains on assets willed to a spouse or donated to a charity, as well as gains in a small business or a farm, and provides additional exemptions (up to $125,000) for gains from the sale of a residence. Several considerations compound the uncertainty of such estimates, which are all much less in absolute terms than those of the last few years:

- There appears to have been an increased preference by the Clinton Administration for an indexing (for price changes) solution to the taxation of capital gains during life. While there are no reliable estimates, approximately one-half to two-thirds of all capital gains would likely remain after indexing.

- Disallowing the stepped-up basis and turning to the carryover basis, rather than the constructive realization of gains at death, appears to have been the preference of policy-makers (although, see Gravelle and Lindsey, 1988). Each of these approaches has its own dynamics relative to such important consequences as earlier realization of gains (e.g., during the decedent's lifetime).

- There is a further possibility that, to gain political acceptability for a change in the tax treatment at death, a compromise **lesser** rate was to have been reached regarding gains realized during lifetime.
- Were there any changes in the treatment at death, commentators believe that there would be additional small-entity exemptions, phase-in transitions, and other mitigating features.

During the 90s there have been additional, ongoing analyses by, for example, Price Waterhouse and the American Council for Capital Formation (ACCF), supplementing the CBO, Tax Expenditures, Treasury, and Congressional estimates. What is safe to say is that the variety of policy options do not merely compound the uncertainty of the revenue estimate. Rather, depending on the combination of policy changes (in terms of the specific details of each of the options), the willingness to engage in capital asset acquisitions and sales will change fundamentally, while the **timing** of gains and losses also changes. In economic parlance, the demand for and supply functions of capital assets will be altered.

Aside from its uncertain but clearly substantial revenue consequences, a variety of economic and equity reasons are advanced for reform of the tax treatment of assets at death (Steger, 1957, 1959, 1961; Surrey, 1941; CBO, 1992; Butters, 1953):

- Reducing the disparity between those who save through an appreciating asset and those whose income is entirely taxable (i.e., the Haig-Simons-Vickery economic concept of taxable income)

- Reducing the incentive for investors to hold assets until death to avoid capital gains taxes (the "lock-in" effect), thus diminishing (or preventing) the blocking of otherwise economically efficient investment decisions

- Assessing a tax on income at death involves adverse consequence for economic incentives and efficiency during lifetime, both for the decedent and their heirs.

And the obvious difficulties of changing the current treatment:

- The forcing of asset sales to pay taxes

- The difficulty of determining the basis of assets (particularly in closely-held businesses)

- The inequity (if there is no grandfathering) of taxing where no tax was anticipated

- Discouraging saving and taxing unreal (e.g., “inflation-caused”) gains.

The Bush Administration appears to support the tax treatment at death for unrealized gains described in the Kyl-Breaux Estate Act of Tax Elimination Act of 2001. (There are similar arrangements in other bills.) The proposal allows every individual to continue to step-up the tax basis of assets in his or her estate to the fair market value at the date of death, subject to an overall limitation on untaxed capital gains of $2.8 million per individual (or $5.6 million per married couple). The per-person exemption would be indexed for inflation. The limited step-up in basis would protect small estates from any new capital-gains tax liability and reporting requirements. Such liability and reporting requirements would apply only to estates with unrealized gains in excess of $2.8 million (or $5.6 million in the case of a married couple). Other bills take different approaches, also using the decedent’s tax basis in one way or another.

Currently, a number of legislative proposals contemplate the elimination of the estate tax concomitant with partial elimination of the stepped-up basis (over time, or in whole or part) for taxing capital gains. These proposals put forth a variety of alternative tax treatments that would carry over the decedent’s basis, in some form, to the heirs with some schedule for phase-in.

Questions have been raised about these unrealized capital gains -- considered together with the degree to which the estate tax is curtailed or eliminated:

1. What is the current magnitude of these unrealized capital gains and their distribution among asset classes?

2. What would be the **revenue** effects of various treatments (e.g., degree and method of carryover, phasing, grandfathering, etc.)? How would each variation

affect the current estimates of the decrease in tax revenues that would result from repealing the estate tax?

3. What would be the effect on the **economy** for alternative treatment, in terms of jobs and output in specific industrial sectors by state and region. How might these economic effects alter estimates of impacts on tax revenues?

4. What would be the effect on different demographic groups (e.g., income, age, family type) of each treatment variation?

My CONSAD colleagues and I have conducted a preliminary analysis using a regional econometric model and associated analytic software and interpretation of tax research results to estimate the revenue, economic, and demographic consequences of a set of "what if" realization patterns of these capital gains. This research is ongoing.

Estimating Consequences

Our study of the economic and revenue consequences of current legislative proposals is in progress: we anticipate completing our study in four to six weeks. Consider, for illustrative purposes only, that $15 trillion for capital gains (in current dollars) are created and accrued over a 25 to 30 year "generation" of taxpaying earners. This rough estimate draws upon research findings made by Steger (1957, 1959) and, thirty years later, by Gravelle and Lindsey (1988) that: (a) on average, only 3.1 percent of the stock of accrued gains are realized in any given year, over a 25-year period; and (b) that realized capital gains in each year average only 24 percent of the total capital gains accruing to the household sector in that year. These economists, and others, believe that the majority of capital gains, under the current system (with a stepped-up basis), are **never realized**, but, instead, are passed on to heirs with a step-up in basis or given away in a tax-free transaction. It would seem that, were unrealized gains taxed at current capital gains tax rates, either at death or to heirs over their lifetimes, a yearly equivalent of many billions of dollars in **additional** taxable gains might result. How would these complement the current revenue of approximately $90 billion for realized capital gains?

Of course, many new questions are now raised. With proposals for exemptions, a degree of grandfathering, and/or the partial disallowance of the stepped-up basis, the questions include: Might there be another $1-2 trillion realized during lifetime (subject, of course, to the specific exemption levels, capital gains regulation changes, income tax rates, etc.)? Would the type and quantity of capital assets (e.g., degree of risk) fundamentally change? Would there be many unanticipated, inequitable consequences? Would there be a number of formerly non-taxed estates (e.g., both estate and income tax) subject to one or both taxes? Would there now be a sizable increase in the number of lower income decedents subject to a tax at death?

CONSAD is currently involved in a new study of the economic and revenue consequences of current alternative proposals that will be completed in four to six weeks. The study is addressing the following issues related to the reduction or elimination of the estate tax and its capital gain correlates:

- Federal government revenue changes (from both the income and the estate tax),
- Changing patterns of capital gains realization,
- Changing acquisition and disposition patterns of capital assets.

The possible **economic** and **fiscal** impacts range from relatively minor to significant. The purpose of our research is to narrow the range of prospective outcomes, such that they will provide information helpful in distinguishing among alternative policy options.

In addition, though, a study of the positive aggregate economic effects of the elimination of the estate tax (CONSAD, 2001) which employed the most widely utilized regional econometric model, found that reducing or repealing the estate tax would free up substantial resources for alternative purposes. The heirs of people who die would inherit additional funds that otherwise would have been collected as taxes. Also, the resources that people now expend (i.e., planning costs) to mitigate the consequences of the estate tax would be released for other uses. We also discovered that the aggregate gains in value added in the majority of U.S. industry substantially exceeded the decreases that would occur in the few industries that would experience decreases in demand for their services due directly or indirectly to the reduction or repeal of the estate tax. This research also established the additional benefit, particularly in tight economic times, of making the reduction or elimination take place as quickly as possible, including immediately. Our ongoing research is anticipated to alter these estimates only slightly while, at the same time, realizing increased revenues to the Treasury.

Interim Results

The combination of the estate tax **and** the stepped-up basis at death determine the total tax paid by estates and their heirs. So, alternately will a system with **no** tax (at death) on estates **and** a carryover (primarily) of basis. However, just as it took time for the current system to settle into a relatively predictable pattern, it will take years for any new system to settle into **its** routine.

The implementation of the stepped-up basis for capital gains taxes resulted in a reduction in Treasury revenue, reducing, in essence, the revenues from the estate tax. Similarly, the carryover of basis will increase Treasury revenues, replacing, to an extent, the loss of the estate tax revenue.

We have made a rough estimate, to be refined during our study in the next several weeks, of the extent of this replacement of estate tax revenue loss. It falls primarily into two categories:

1. Increased realization by some of those currently in the 50 (plus) age bracket who, until now, have been holding appreciated assets, waiting for death to provide their heirs with a stepped up basis. We refer to these as "unlocked seniors". We could anticipate this phenomenon will continue for 20-30 years following the repeal of the estate tax and change to the carryover basis.

2. The much larger revenue replacement will be the result of the loss of stepped-up basis by heirs of these decedents. Heirs of decedents in year 1 will (generally) realize **many** (but not all) of their inherited gains sometime during their lifetime (say, a 30-35 year period) and pay a significantly larger tax than they would have had the stepped-up basis obtained. We refer to this group as the "carried-over heirs".

Unlocked seniors -- Our interim estimates of revenues gained from earlier capital gains realization from some "unlocked seniors" were produced for four household groups ranging from ages 65 to 85 and over. The data consisting of household characteristics (i.e., age, wealth, assets, net worth, etc.), and death and life expectancy rates, were collected from the Census Bureau's Statistical Abstracts, Current Population Reports and Household Net Worth and Asset Ownership Studies. The earlier realization coefficients, applied to the wealth of these wealthy seniors, were derived for an as-of-yet unpublished article by two Treasury researchers (Auten and Joulfaian, 2001) which estimated capital gains realization rates using a two stage tobit regression in their paper "Bequest Taxes and Capital Gains Realizations." Auten and Joulfaian calculated coefficients for realizations that we applied to the total net worth estimates. First, we calculated total realized gains for the life expectancy of the households according to these estimated coefficients ($23.2 billion). Then we assumed that households would act as they did at age 65 with no estate tax, retaining their coefficient until death, and calculated total realized gains for their life expectancy ($24.9 billion). The difference of $1.7 billion annually is the estimated increase in realized capital gains (with the elimination of the estate tax) by these "unlocked seniors".

Carried-over heirs -- The most recent estimate of additional revenues resulting from heirs who would now be subject to the carryover, not the stepped-up basis (Congressional Research Service, 2000), places the range between $1 - $4 billion annually. We believe it will be significantly higher than this, though we are unclear as to the CRS methodology.

To estimate the effect of the elimination of the stepped-up basis on the capital gains taxes paid by the heirs of decedents on the accrued capital gains in their inheritances, we first apportioned the total capital gains that were realized in 1997 between the portion of the population that were required to file estate tax returns and the remainder of the population. The apportionment has been based on the estimates developed by Burman and Ricoy for the portion of capital gains realizations in 1993 that were performed by families in specific income categories.

We then divided total capital gains realized by families in each income category by the estimated number of households in that income category. The resulting ratio was next multiplied by the number of decedents in that population group (i.e., the number of people who filed estate tax returns in 1997, and the number of other people who died in 1997). This calculation is based on the assumption that the heirs will realize the capital gains on their inherited assets in approximately the same manner as realizations which were occurring in 1993 among people in their (or, more accurately, their benefactor's) income category, but will now be liable for payment of capital gains on those realizations. Previously, no capital gains taxes were owed on these amounts because of the step-up in the basis for the inherited assets. We then estimated that capital gains taxes would be collected on those realizations at the effective (1997) tax rate of 21.7 percent.

These calculations produced the estimate that capital gains tax revenues would increase by approximately $4.3 billion in the first year after the estate tax is repealed, if total capital gains realizations in that year were equal to those observed in 1997. Of that amount, $3.6 billion would be paid by the heirs of decedents for whom estate tax returns would have been filed, and the remaining $0.7 billion would be paid by the heirs of other decedents. Significant additional tax revenues (e.g., $12 to $20 billion, annually) would be obtained in subsequent years as additional portions of the accrued capital gains in the inherited assets are realized, and as additional decedents bequeath assets with accrued capital gains that previously would have been exempted from capital gains taxation due to their step-up in basis. Thus, the total increase in capital gains tax revenues in any year after repeal of the estate tax would be several times larger than the amount estimated for the first year after repeal. A method for estimating that total increase is currently being developed and results will be available in four to six weeks.

Total revenue gains -- Across these two components, our preliminary estimate is that revenue gain will exceed $5 billion annually in the first year and, then, by the fifth year rise to more than $15 billion annually for many years.

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